

66. BT's charges are currently based on historic fully allocated costs. They have not been set by OFTEL, but have been checked, to ensure that they are consistent with the wholesale charging requirements under Condition 13 of BT's Licence. BT has published contracts and quality of service levels. MFS and Energis have signed up to these contracts and are receiving service. Prices include digital cross connect activation which BT is obliged to supply under Condition 13 (for which we understand a separate charge is made in the US).

67. The December 1996 OFTEL consultation on network charge control from August 1997 was published before IFL licences had been issued or BT had launched its ISH product. It did not therefore cover any international products. We do not consider that ISH will become competitive within the period of the next price control and so propose to control it as a non-competitive interconnect specific service. The starting charge will be set based upon forward looking incremental costs to which we will apply an indexed (downward) cap. We intend to publish these proposals in our March consultation "Network Charges from 1997".

Undersea cables: UK regulation

68. OFTEL does not regard international cable capacity as a bottleneck controlled by BT, but does have some concerns in the short term about its availability and price to new UK international facilities licensees. These concerns are as a result of liberalisation and not as a result of the BT/MCI merger. Although our concerns are brought into focus by the merger, OFTEL does not believe that concerns should be addressed by conditions imposed as part of the merger investigation, but rather through a wider co-operative investigation into the operation of cable consortia by UK, European and US authorities. We are currently undertaking such an investigation in the UK, and are of the view that if action needs to be taken it will probably need to encompass all consortia members, as the voting structures of the consortia (ie greater than 50% of MTU holders must vote in favour of any rule changes) mean that regulation of any one operator (even a combined BT/MCI) is unlikely to address our concerns.

69. Unutilised capacity may be held either by:

- individual consortium members; or
- by a consortium as common reserve.

70. Operators wanting to buy capacity may be either:

- existing consortium member (eg AT&T, MCL, Sprint, etc); or
- new UK international licensees who are not co-owners (eg Energis, Esprit, etc).

71. The two classes of operator are in very different positions - the co-owners have had opportunities to buy capacity as MIU and can buy common reserve capacity from the consortium. Non-co-owners are faced with restrictions on capacity they may acquire and a pricing policy that may have little relation to the economic value of the asset they are acquiring.

72. By examining the activation records held by the landing party at either end of the cable (AT&T in the US and BT and Mercury in the UK) it is possible to establish which 2Mbits/s circuits have been activated (and are in use) and those that are not and are being held in anticipation of future needs by co-owners. It is also possible to identify, by comparing user admin records (ie IRU owners) with owner admin records exactly how many IRUs have been sold by co-owners.

73. Whilst co-owners have the opportunity to purchase whole capacity circuits non co-owners are faced with difficulties of persuading two operators to sell them matched capacity. This may be a "catch-22" situation with neither operator prepared to sell without the prior agreement of the other. The far-end operator is outside the jurisdiction of the near-end national regulator and this may cause difficulties in resolving the problem.

74. Recognising the difficulties in this area, OFTEL believes that it has implemented robust regulation (but recognises it can only regulate UK-end circuits and UK based operators). BT and Mercury and the new IFL operators are, or shortly will be in the case of Mercury, regulated by fair trading condition (based on Articles 85/86 of the Treaty of Rome and maintenance of effective competition condition.

75. OFTEL has indicated to BT and Mercury that as a minimum obligations it expects them to act as brokers for new (non co-owner) UK licensees and to convert IPLCs to IRUs. They are both doing this.

76. BT have told us that they intend to sell (at least) sixty-three (63) 2 MBits/s whole circuit MIUs from TAT 12/13 to non-consortia members. They have also offered to sell BT owned UK half circuits to US correspondents, if asked to do so.

77. A concern has been raised that if BT/MCI were to self-terminate there is insufficient capacity for AT&T to retaliate. OFTEL understands that BT and AT&T currently use 411 2 MBits/s circuits on the UK/US route for correspondent traffic. AT&T owns (but does not use) 473 whole 2 MBits/s circuits in TAT 12/13 and so has sufficient international capacity to self-terminate currently. As discussed, above BT is obliged to provide cable station access and backhaul. There are four national long-distance networks in the UK (Mercury, Energis, RACAL, Energis and NTL) aside from BT and BT is obliged to provide call termination at cost.

78. The following is a summary of total current cable design capacity (amount of capacity a cable is designed technically to carry) between the UK and the US¹:

| CABLE | SDH/PDH | DESIGN CAPACITY | LANDING STATION |
|-----------|---------|--------------------|-----------------|
| CANTAT-3 | SDH | 2 +1 x 2.5 GBits/s | Redcar |
| PTAT | PDH | 3 +1 x 140 MBits/s | Brean Sands |
| TAT-8 | PDH | 2 +1 280 MBits/s | Widemouth Bay |
| TAT-9 | PDH | 2+1 x 565 MBits/s | Goonhilly |
| TAT-11 | PDH | 2+1 x 565 MBits/s | Oxwich Bay |
| TAT-12/13 | SDH | 2+2 x 5GBits/s | Lands End |

79. Taking all the US/UK cables as a whole, and extracting ownership percentages (rounded to nearest whole number) from the ownership schedules to the cable construction and maintenance agreements ("C&MAs") (as at end Jan '97) gives the following ownership percentages of the notional capacity (capacity which has been subscribed for by cable consortia members) between the UK and the US (showing only those with over 1 % of the total - there are many operators holding smaller percentages):

¹ $n + m \times$ "Capacity" means $n \times$ "Capacity" available for traffic plus $m \times$ "Capacity" dedicated for restoration

| OPERATOR | % Holding "US-end" | % Holding "UK-end" | % Holding total |
|--------------------|-----------------------|--------------------|-----------------|
| AT&T | 29% | 9% | 19% |
| BT | 5% | 22% | 13% |
| Telelobe | 13% | 9% | 11% |
| DT | 9% | 12% | 11% |
| MCI | 18% | 5% | 11% |
| C&W/MCL | 1% | 7% | 4% |
| FT | 1% | 6% | 4% |
| Netherlands PTT | 1% | 6% | 3% |
| MFS/World Com | 5% | 2% | 3% |
| Sprint | 5% | 1% | 3% |
| Telia | 3% | 2% | 2% |
| Telefonica | 0% | 4% | 2% |

The notional capacity on the UK route is around 95% of the current design capacity, leaving around 5% of the design capacity as common reserve capacity (capacity not owned or subscribed for by a consortium member on a consortium cable) held by the consortia (chiefly on TAT 12/13, although some is available on CANTAT-3).

80. If BT and MCI holdings are taken together; FT, DT and Sprint holdings (ie Global One) are taken together and AT&T and Unisource are taken together then table looks like this:

| OPERATOR | % Holding "US-end" | % Holding "UK-end" | % Holding total |
|--------------------------------------|-----------------------|--------------------|-----------------|
| AT&T/ NPTT/ Telia / Telefonica | 33% | 21% | 26% |
| BT/ MCI | 23% | 27% | 24% |
| DT/FT/Sprint | 16% | 19% | 18% |
| Telelobe | 13% | 9% | 11% |
| C&W/MCL | 1% | 7% | 4% |

| | | | |
|------------------|----|----|----|
| MFS/World Com | 5% | 2% | 3% |
|------------------|----|----|----|

81. Although much transatlantic capacity is now allocated (although interestingly not used - source - cable activation records) OFTEL understands that extensive new capacity is due to come on-line in the next two years (and that 2 years is the lead time for new trans-Atlantic cables):

- Gemini (MFS/C&W cable) - March 1998
- TAT 12/13 expanded by 50% mid-1998, by 50% more mid- 1999

VI. PROPORTIONATE RETURN, PARALLEL ACCOUNTING AND SELF CORRESPONDENCE

82. A number of respondents have expressed concern about the potential for abuse, or manipulation, of the accounting rate system as a result of BT and MCI's ownership of facilities at both ends of the UK - US route. Their concerns fall under three broad heads:

- self-termination;
- BT's control of termination facilities; and
- hubbing of UK third country traffic through MCI.

83. To meet these concerns the respondents suggest the continued application of the existing conditions, and further regulation

Self - Termination

84. The primary concern is that to the extent that the proportionate return rules are relaxed on the UK- US route BT will have the opportunity and incentive to route US destined traffic disproportionately or exclusively to MCI. BT/ MCI could undercut competitors by charging each other low settlement rates whilst raising settlement rates to other operators

85. The view of the UK government is that the economic welfare of both the UK and the US would be augmented if there was full competition in the provision of international telecommunications traffic between the US and the UK.

86. The degree of competition will be enhanced where there is a multiplicity of operators with end-to-end control. This is true as long as all operators have the possibility of acquiring end-to-end control. Currently, BT does not have end-to-end control, although AT&T, MFS-Worldcom, Sprint, ACC, etc do have facilities at both ends.

87. End-to-end control enhances competitive pressures because it allows delivery of traffic at non-accounting rate prices and encourages operators using accounting rates agree lower settlement rates.

88. Accounting rates for the carriage of international traffic are above cost, and reflect a world where one operator in each country set a monopoly price to operators from other countries in order to terminate their traffic. When the US first liberalised routes and the UK created a duopoly, they were obliged to create regulatory rules which constrained their carriers to act towards external monopolists as if they were a single entity. This was in order to prevent far-end monopolists exploiting the development of competition through one-way bypass or whip-sawing which are dealt with by rules on proportionate return and parallel accounting respectively. However, in respect of routes which are liberalised, and subject to the proviso that entry barriers are dismantled, there is merit in retaining such rules only as reserve safeguards.

89. The problems identified above apply where there is liberalisation at one end only. On a route liberalised at both ends, any operator which felt that the terms offered for termination of its traffic at the far end were inferior could respond by establishing its own affiliate or threatening to do so.

90. For the point in the previous paragraph to be true, it is of course necessary that the entry barriers to setting up alternative international facilities must be dismantled. It is OFTEL's objective to ensure that this is the case and the mechanisms are set out earlier in this response.

91. Retention of parallel accounting on a competitive route would be likely to inhibit the reduction of prices to levels that one might expect to find in a competitive market. A lower accounting rate offered to one other party (or affiliate) would immediately be available to all other parties. The risk is that this would lead to focal point pricing. Awareness of the price would lead other parties to make simultaneous price reductions; consequently, no rational operator would reduce its price since it would not result in a compensatory gain in market share.

92. Retention of proportionate return reduces the flexibility of operators to pass and receive different volumes of traffic from other operators, which they may wish to do to fill capacity efficiently.

93. For the reasons outlined above, the UK has lifted the requirements for parallel accounting and proportionate return in respect of competitive routes (including the US/UK route).

94. The US has adopted a similar policy in its Flexibility Order. However, the US has adopted a policy with greater emphasis on regulation rather than competition. It requires operators with a market share of 25% or greater on any in-bound or outbound route to observe non-discrimination. This could have an effect not dissimilar to the parallel accounting rate rule in respect of the larger operators. However, we note that this rule does not apply to operators with less than 25% market share, whose actions will presumably require the larger operators to reduce prices in order not to lose market share to these smaller operators.

95. The US is also proposing to introduce a benchmark on each international routes which all accounting rates offered by operators would need to met. This is another possible mechanism for bringing down accounting rates, which in principle we welcome. The UK has set out its position in full on this in our response to the benchmarking proposals, but is concerned that there is a risk that on competitive routes this may create an artificial target price higher than the competitive level.

96. The UK Government views the potential merged BT/MCI entity as both a reflection of the economic realities of a liberalised UK-US route and, given an appropriate environment, a likely active agent for lower accounting rates (or their alternative).

Routing

97. Respondents were concerned that BT could discriminate in its routing of US destined traffic. AT&T (page 11, second paragraph) gives as an example BT returning traffic to MCI in the off peak hours allowing MCI to make more efficient use of its facilities relative to US firms or sending traffic to MCI using preferred transmission media and using less desirable satellite facilities for MCI's competitors in the US.

98. In respect of the suggestion that BT/MCI might discriminate in the choice of transmission media it is questionable whether it would be in BT's commercial interest to send traffic over alleged sub-standard satellite links as this would reflect badly on BT carrier services and ultimately may effect their customer perception.

99. In respect of rerouting, other operators have alternative operators at both ends of the UK/US route with which they can terminate traffic. If they are disadvantaged by BT's rerouting of its traffic they could be expected to retaliate against BT. For

operators facing higher unit costs through less efficient network usage there are a number of things adversely affected US carriers could do to optimise network usage. They could link up with affiliates to send off-peak hour traffic back to the US or enter into mutually beneficial arrangements with unaffiliated companies to make more efficient use of both companies facilities. They would also be in a position as indicated above to self terminate or use other operators facilities and would need not rely on BT's transmission facilities. Alternatively they could engage in refile with countries who have mutually beneficial time differences.

Hubbing

100. Respondents pointed to the potential for BT to "balance off" its UK traffic stream with third countries by sending surplus minutes to MCI for re-origination in the US. Since the traffic reoriginated in the US is included as part of the MCI's market share for determining return traffic, the third country terminating carrier would allocate a greater share of the return minutes to MCI (and shift minutes away from other US competitors on the route), than it would have received based on actual US customer tariffs. It is suggested that to prevent this BT should be prohibited from routing its traffic through MCI to third countries.

101. Whether there is an incentive on BT to act in this manner depends on traffic flows and accounting rates on a particular route. It is an empirical question and would require detailed worked examples on specific routes to be analysed before this question could be answered.

102. The success of this strategy is again predicated on a zero response from other operators. This might not be realistic as this strategy is likely to have an adverse effect on the third country. If it caused significant distortions it is likely that there would be retaliation from the third country, most obviously by abandoning proportionate return and directing traffic away from BT/MCI.

103. Adversely affected US carriers are in a position to do something similar. US carriers can link up with subsidiaries or global partners within other jurisdictions and can rebalance and reoriginate in a similar manner eg a US operator can send traffic to the UK for reorigination, reducing BT's proportionate return.

104. On the basis that other US carriers can carry out similar activities, the efficient use of transmission capacity would appear to be in the interest of both UK and US

customers and lead to a potential lowering of collection tariffs in the event that the cost savings achieved by such use are passed on to customers.

Control of Facilities

105. The respondents argue that there is no viable alternative to BT for the termination of US carrier traffic in the UK, allowing BT to charge above cost settlement rates for call completion.

106. The key question is whether at each point in the chain of transmission, termination at cable stations, backhaul, long distance transport, local loop termination there is either sufficient competition from alternative carriers or effective regulation which enables carriers to obtain cost-based transmission. Any US carrier can deliver its traffic to a UK licensee for delivery in the UK, and that could be any one of 44 international facilities licensees, all of whom, on the UK side are free to negotiate competitive settlement rates. This would only not be the case were the FCC to decline to lift the ISP on this route or for these operators. Calls needing to be terminated with BT customers would still ultimately be handed over to BT, but under the cost-based non-discriminatory interconnection terms described earlier. BT would be unable in that situation to leverage its local access strength to maintain above cost international settlement rates. Finally, it can only be reasserted that such behaviour would be in breach of the Fair Trading Condition of its licence which prohibits such misuse of market power

Alternative Facilities

107. Respondents claim that self correspondence/by pass is uneconomic because the cost of installing alternative facilities would not be below the effective settlement rate the costs of facilities and carrier costs cannot be offset by a share of the UK outbound market because the ability to do so is constrained by the lack of equal access.

108. UK's position on equal access is described above. The argument that it is not economically viable to build alternative structures appears to be at odds with other statements that settlement rates are too high. The major criticism of settlement rates is that they do not reflect the actual cost of termination. Here the respondents seem to be arguing that the costs of termination are high.

109. The alternative interpretation of the argument is that prices are now so low that the key component is unit cost driven by volumes. Operators who fill their circuits most effectively will have the most cost advantages. It is true that there are some cost advantages through efficient use of capacity. However it is possible for other carriers to respond by refiling traffic from third countries through the UK to fill their capacity. The experience of ISR operators in the UK suggests that concern about inability to fill capacity is misplaced. ISR operators have captured 27% percent of the market share from BT and Mercury on US routes (by retail revenue for the period September - December 1996).